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Chairman Shelby, Ranking Member Brown, distinguished members of the Committee, it is my pleasure to appear before you today, five years after enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

That Act was passed in response to the worst financial crisis since the Great Depression. In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of households their jobs, their homes and their livelihoods. The crisis was rooted in years of unconstrained excesses and prolonged complacency in major financial capitals around the globe. The crisis demanded a strong regulatory response in the U.S. and globally as well as fundamental changes in financial institution management and oversight world wide. The U.S. has led these reforms, both domestically and internationally.

In the U.S., the Dodd-Frank Act created the authority to regulate Wall Street firms that pose a threat to financial stability, without regard to their corporate form, and to bring shadow banking into the daylight; to wind down major firms in the event of a crisis, without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities through the Volcker Rule and other measures, regulate repo and other short-term funding markets, and beef up banking supervision and increase capital; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the derivatives market; to regulate payments, settlement, clearance and other systemic activities; to improve investor protections; and to establish a new Consumer Financial Protection Bureau to look out for the interests of American households.

I want to focus today on aspects of the system of prudential oversight established in the Act.

I. Supervision of Bank Holding Companies

The Federal Reserve has supervisory authority, as it has long had, over bank holding companies. The Fed is directed under section 165 of the Act to provide for a graduated system of regulation, with increasing stringency, depending on the risk that the firm poses to financial stability, based on its nature, scope, size, scale, concentration, interconnectedness or other factors. The Fed may tailor these more stringent prudential standards for individual firms or categories of firms, based on a similar set of factors regarding risk.

These enhanced prudential measures include risk-based capital requirements and leverage limits, liquidity requirements, risk management, resolution planning, credit exposure reporting, concentration limits, and annual stress tests.

The Fed is not required under this provision to apply these more stringent standards to bank holding companies with assets under $50 billion. Annual firm-led stress tests, however, are required for firms between $10 and $50 billion in size, and the Fed must itself stress tests firms over $50 billion in size, in addition to such firms semi-annual firm-led stress tests. Publicly traded bank holding companies $10 billion in asset size and above must establish risk committees. (I should also note that under the Act, the Federal Reserve may, upon recommendation of the Financial Stability Oversight Council, raise the threshold above $50 billion for certain prudential standards, those involving contingent capital, resolution planning, concentration limits, enhanced public disclosures and short-term debt limits.)

None of these enhanced measures apply to about 95% of banks, the category commonly described as community banks, those under $10 billion in assets—more than 6,000 banks in communities all across the country.

Graduated standards are already at work. Fed stress testing applies to the largest firms in the country, the 31 firms with assets of $50 billion and above. Such firms represent a wide variety of risk profiles, business strategies, sizes, specializations, and include both foreign and domestic firms. The largest, most complex financial institutions face the most stringent standards, as provided for under the Act. The Fed, for example, imposes a supplementary leverage ratio, a counter-cyclical capital buffer, and detailed liquidity coverage rules only on 14 firms with over $250 billion in assets. The very largest U.S. banks on a global basis, currently eight bank holding companies, are subject to even tougher standards, including capital surcharges, more stringent leverage ratios, and long-term debt requirements.

In my view, this graduated approach to supervision and regulation makes sense. Some have argued that the size threshold for heightened prudential standards should be substantially increased, while others have argued that banks should not be subject to any heightened standards unless they are specially designated as systemic. Both approaches, in my judgment, are mistaken.

First, as to size, some have mistakenly said that the Act describes firms with only $50 billion in assets as systemic. But that is simply not the case. Congress set the $50 billion threshold, and another threshold for other measures at $10 billion, to provide a floor under which smaller firms would know that they are not subject to the new sets of rules. But the rules were not meant to only apply to the very few largest firms in the country. They are not intended to apply only to systemically important firms.

They are designed to work in a graduated, tailored way to increase the resiliency of the financial system as a whole. Risks aggregate across the financial system, including from institutions of a variety of sizes and types. It is the very anti-thesis of macro-prudential supervision to focus only on the very largest handful of financial firms and to ignore risks elsewhere in the system. Moreover, smaller financial institutions themselves face risk from larger institutions and from activities across the system as a whole. Understanding those risks is essential if we are to have a safer financial system than the one we had before the financial crisis. We must not intentionally blind regulators to these risks in advance.

Second, as to the idea of designation, others have argued that bank holding companies should have to be designated for heightened supervision by the same process the FSOC uses for non-bank firms. But that runs counter to the purpose of nonbank designation. Bank holding companies should not be required to be designated for heightened supervision. Bank holding companies are already supervised by the Fed, and the Fed already has authority to impose heightened prudential supervision on such firms, on a graduated basis, as they increase in size and complexity.

The reason for the designation process, under section 113 of the Act, for nonbank financial institutions is that such institutions were not subject to meaningful, consolidated supervision by the Fed at all. Firms such as Lehman Brothers and AIG could operate with less oversight, more leverage and riskier practices. Recognizing that policing the boundaries of financial regulation is critical to making the financial system safer, fighting regulatory arbitrage, and providing oversight of shadow banking, the Dodd-Frank Act established a process for bringing such non-bank financial institutions into the system of regulatory oversight.

It makes little sense to require designation of firms that are already supervised by the Fed, and it will dramatically slow down and disrupt the Fed's existing oversight system. It will make the financial system weaker, not stronger.

None of these changes will help truly small, home-town banks. There is undoubtedly much that could be done to reduce regulatory burden on the smallest banks. Small banks could benefit from clear safe harbor rules and short, plain-language versions of regulations that do apply to them. The Fed can continue to improve its tailored and graduated approach to supervision. Strong, compliant small banks should have longer examination cycles and streamlined reporting requirements. Regulators and the industry should come together in a task force to come up with better ways to implement the goals of the Bank Secrecy Act and related rules to make it more likely that we catch terrorists and criminals, with lower regulatory burden. And we need a level playing field for small business lending, so community banks can compete with non-bank providers to provide safe, transparency, consumer-friendly loans to small businesses and entrepreneurs.

II. Non-bank designations and the Financial Stability Oversight Council

Critics have also attacked the work of the Financial Stability Oversight Council, or FSOC. FSOC has authority to designate systemically important firms and financial market utilities for heightened prudential oversight by the Federal Reserve; to recommend that member agencies put in place higher prudential standards when warranted; and to look out for and respond to risks across the financial system.

One of the major problems in the lead up to the financial crisis was that there was not a single, uniform system of supervision and capital rules for major financial institutions. The federal financial regulatory system that existed prior to the Dodd-Frank Act developed in the context of the banking system of the 1930s. Major financial firms were regulated according to their formal labels – as banks, thrifts, investment banks, insurance companies, and the like—rather than according to what they actually did. An entity that called itself a "bank," for example, faced tougher regulation, more stringent capital requirements, and more robust supervision than one that called itself an "investment bank." Risk migrated to the less well-regulated parts of the system, and leverage grew to dangerous levels.

The designation of systemically important non-bank financial institutions is a cornerstone of the Dodd-Frank Act. A key goal of reform was to create a system of supervision that ensured that if an institution posed a risk to the financial system, it would be regulated, supervised, and have capital requirements that reflected its risk, regardless of its corporate form. To do this, the Dodd-Frank Act established a process through which the largest, riskiest, and most interconnected financial firms could be designated as systemically important financial institutions and then supervised regulated by the Federal Reserve. The Council has developed detailed interpretive guidance and a hearing process that goes beyond the procedural requirements of the Act, including extensive engagement with the affected firms, to implement the designation process outlined in Dodd-Frank. The approach provides for a sound deliberative process; protection of confidential and proprietary information; and meaningful and timely participation by affected firms. The Council has already designated a number of firms under this authority.

Critics of designation contend that it fosters "too big to fail," but the opposite is true. Regulating systemically important firms reduces the risk that failure of such a firm could destabilize the financial system and harm the real economy. It provides for robust supervision and capital requirements, to reduce the risks of failure, and it provides for a mechanism to wind down such a firm in the event of crisis, without exposing taxpayers or the real economy to the risks of their failure. The FDIC is developing a "single point of entry" model for resolution that would allow it to wind down a complex financial conglomerate through its holding company with "resolution-ready" debt and equity, while permitting solvent subsidiaries to continue to operate. Similar approaches are being developed globally.

Other critics argue that the FSOC should be more beholden to the regulatory agencies that are its members, but again, the opposite is true: Congress wisely

provided for its voting members, all of whom are confirmed by the Senate, to participate based on their individual expertise and their own assessments of risks in the financial system, not based on the position of their individual agencies, however comprised. Members must individually attest to their assessments in the FSOC's annual reports. The FSOC has the duty to call on member agencies to raise their prudential standards when appropriate, and member agencies must respond publicly and report to Congress if they fail to act. This system of checks and balances requires that FSOC members leave their agency's "turf" at the door, and focus on system-wide risks and responses. If anything, the FSOC's powers should be strengthened, so that fragmentation in the financial regulatory system does not expose the United States to enormous risk, as it did in the past.

Some critics contend that certain types of firms in certain industries or over certain sizes should be categorically walled off from heightened prudential supervision, but such steps will expose the United States to the very risks we faced in the lead up to the last devastating crisis. The failure of firms of diverse types and diverse sizes at many points in even very recent memory—from Lehman and AIG to Long Term Capital Management—suggest that blindspots in the system should at the very least not be intentionally chosen in advance by the Congress. The way to deal with the diversity of sizes and types of institutions that might be subject to supervision by the Federal Reserve is to develop regulation, oversight and capital requirements that are graduated and tailored to the types of risks that such firms might pose to the financial system, as the agencies have been doing. FSOC and member agencies also have other regulatory tools available with respect to risks in the system for firms not designated for Fed supervision, including increased data collection and transparency, collateral and margin rules for transactions, operational and client safeguards, risk management standards, capital requirements, or other measures.

Some critics complain that the FSOC's work is too tied to global reforms by bodies such as the Financial Stability Board (FSB). But global coordination is essential to making the financial system safe for the United States, as well as the global economy. The United States has led the way on global reforms, including robust capital rules, regulation of derivatives, and effective resolution authorities. These global efforts, including designations by the FSB, are not binding on the United States. Rather, the FSOC, and U.S. regulators, make independent regulatory judgments about domestic implementation based on U.S. law. And U.S. regulators follow the normal notice and comment process when developing financial regulations. The FSB itself has become more transparent over time, adopting notice and comment procedures, for example, but it could do more to put in the place the kind of protections that the FSOC has established domestically.[1]

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[1] *See* Michael S. Barr, *Who's in Charge of Global Finance?,* GEORGETOWN JOURNAL OF INTERNATIONAL LAW 45, no. 4 (2014): 971-1027.

As with designation, global coordination—and independent regulatory judgment—is essential to capital rules. Strong capital rules are one key to a safer system. Before the crisis, the financial system was woefully undercapitalized, and that the system was saved only with a massive infusion of taxpayer-funded capital, and a wide variety of unprecedented guarantees, liquidity provision and other backstops by the FDIC, the Federal Reserve, and Treasury. There's already double the amount of capital in the major US firms than there was in the lead up to the financial crisis. Globally, regulators are developing more stringent risk-based standards and leverage caps for all financial institutions, and tougher rules for the biggest players. In the U.S., regulators have proposed even stronger leverage and capital requirements for the largest U.S. firms, and other countries are putting in place stricter approaches when warranted by their local circumstances.

In my judgment, the local variation based on a strong minimum standard is healthy for the system, taking into account the different relative size of financial sectors and differing local economic circumstances. There's been progress on the quality of capital—focusing on common equity—and on better and more comparable measures of the riskiness of assets, but more could be done to improve transparency of capital requirements across different countries and to make them stronger buffers against both asset implosions and liquidity runs. We need to continue to insist that European capital standards and derivatives regulations are strong—and enforced even-handedly across the board.

The United States has taken a strong lead in pursuing global reforms, galvanizing the G-20, pushing for the creation of the global Financial Stability Board, and pursuing strong global reforms on capital, derivatives, resolution, and other matters.

The G-20 has been driving financial reforms at a global level; the Financial Stability Board pursues agreement among regulators; and technical teams at the Basel Committee on Banking Supervision, the International Organization of Securities Commission, and the International Association of Insurance Supervisors hash out industry-relevant reforms. While the process of reaching global agreement has at times been quite messy, divisive, and incomplete, the last thing we need is to hamstring global cooperation or U.S. regulation. These mechanisms should be strengthened and improved, not ignored or weakened.

Strong U.S. financial rules are good for the U.S. economy, American households and businesses, and we also need a stronger, harder push to reach global agreement on core reforms. In fact, such an approach is essential in order to reduce the chances of another devastating global financial crisis that crushes the U.S. economy.

III. Measuring Risk

The 2007-2009 financial crisis revealed the pressing need to develop better methods to understand and manage risk in the financial system. Since the crisis, financial regulators, scholars, and the financial industry have turned their attention

to these issues, and made progress, but our ability to identify, monitor, and mitigate risk in the financial system remains far behind where we need to be. This is particularly challenging because many of the risks that are of central concern are low probability events with unacceptably high costs for the real economy.

Stress testing is a central and innovative risk management tool used since the financial crisis by both regulators and practitioners. Stress testing attempts to capture the effects of macro shocks on the balance sheets and activities of firms. Unlike fixed capital ratios, of either the risk-based or leverage ratio type, stress testing seeks to understand how macro shocks would deplete capital. Moreover, the stress tests are not as easy as fixed capital rules for firms to game. Despite these advantages, stress testing remains crude and static with respect to systemic effects, and is focused on the risks facing each individual firm. Although the goal of stress testing is to analyze and measure systemic risk, it is in many ways still stuck measuring the static effects of macro-shocks on units of capital at individual firms.

While there have been significant recent advancements, our current stress tests fail to account for the increased interconnectedness and complexity of the financial system. The models do not yet capture the complex network of financial transactions that connect firms and that can spread and magnify risk in the event of a crisis. The models are not dynamic—meaning, they do not account for market participants' responses to stressful events. Such responses themselves may change the nature of the events in question. Moreover, even if these more robust models existed today, regulators do not, at least as of yet, have full access to the financial data needed to use the models to measure systemic risk.

We need to continue to develop new ways of thinking about how to identify, measure, and mitigate systemic risks by drawing on methods from other disciplines and experience from other sectors that face systemic risks. We should explore how methods from other disciplines—such as system analysis, agent-based modeling, machine-based learning, behavioral finance, and data visualization and security—can be used to improve stress testing and financial risk management practices and regulation. We should also examine how risk is measured, monitored, and mitigated in other sectors and contexts, such as in supply chains and electrical grids, and in the context of climate change; how stakeholders in these contexts make tradeoffs between stability, efficiency, and innovation; and how lessons from these contexts should be applied or adapted to understand risks in the financial system.

At the end of the day, no one model will be adequate to understanding and measuring risk in the financial system. We will need to improve stress testing, early warning, macro asset, equity, and credit price models, and other ex ante measures of risk. We will need to do better at crisis monitoring and response, including resolution of failing firms during a crisis. We will also need to develop better ex post analytics to understand the crisis that have occurred.

IV. The Path of Reform

The Dodd-Frank Act laid a firm foundation for a more resilient financial sector, one that works for American families, instead of exposing us all to needless risk and harm. Since enactment, a new Consumer Financial Protection Bureau has been built from scratch. New rules governing derivatives have been implemented to bring trading out of the shadows and reduce risk through central clearing, capital and margin requirements. A resolution authority has been put in place to deal with failing firms so we are no longer faced with the devastating consequences of the failure of a firm like Lehman Brothers or the untenable bailouts of firms like AIG. Regulators have the ability to designate large firms for supervision by the Fed, so the financial sector can no longer avoid stringent regulation just by altering their corporate form. The largest firms have to hold a lot more equity capital as a buffer against losses, and the Volcker Rule, heightened prudential supervision, stress tests and other measures are reining in risk.

The U.S. financial system is more resilient than it was in 2008. But there's still much work to do.

We need to keep pushing for stronger reforms of the largest, most complex banks and other financial institutions. Stress testing and new capital rules have dramatically increased the levels of capital at the largest firms, but we do not yet know whether these levels are sufficiently robust to withstand a severe financial crisis. A bank liability tax could help further reduce incentives to take on risky short-term debt. And shadow banking activities, repo and securities financing transactions, and other activities need to be made safer with strong margin and collateral rules. We need to better align manager's incentives with financial stability, by putting banker bonuses at risk when a firm's capital level drops below specified levels or when the firm is hit with fines or sanctions.

More broadly, Fannie Mae and Freddie Mac remain in conservatorship without a decision about long-term housing finance; money market mutual funds remain susceptible to runs; certain high-frequency trading strategies and market structure problems threaten financial stability and undermine the fairnesss of our markets; and critical investor protection authorities have gone unused.

To be clear: the financial system is safer, consumers and investors better protected, and taxpayers more insulated, than they were in 2008—by a lot. But that is not enough. We need to stay on the path of reform to make the financial system safer, fairer, and better harnessed to the needs of the real economy. We need to keep pushing for a financial system that works for us.